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SUBJECT: BRV DEBT MANAGEMENT STRATEGY

REF: CARACAS 03782

11. (U) SUMMARY: Since Chavez assumed office in 1999, BRV debt stock increased 70 percent, to USD 46.6 billion at the end of 2005. In 2005, debt stock grew by USD 5.4 billion, despite an estimated 2005 total central government fiscal surplus of approximately USD 3 billion. Despite the increase in public debt, most analysts agree that the current 35 percent debt-to-GDP ratio is very manageable, given current economic growth rates (9.3 percent in 2005). For 2006, Finance Minister Merentes announced the BRV debt management strategy would be to use oil windfall revenue to prepay USD 4.7 billion in foreign debt (USD 3.9 billion in Brady bonds and USD 700 million in bilateral and multilateral debt) and improve the maturity profile of domestic debt. The BRV's new goal is to reduce debt as a percentage of GDP to 31.4 in 2006 and to 27.4 percent in 2007. The Finance Ministry estimates saving USD 676 million in debt service in 2006 and USD 450 million in debt service a year starting 2007. END SUMMARY.

OVERALL DEBT BURDEN

12. (U) Despite increases in public debt, most analysts agree that debt as a percentage of GDP is manageable, given the strong economic growth (9.3 percent in 2005). At the end of 1998, just before Chavez assumed office, public debt as a percentage of GDP was 29.6 percent, as compared to 35 percent for 2005. From 1998 to 2005, domestic debt stock increased from USD 4.1 billion to USD 15.5 billion and foreign debt stock increased from USD 23.3 billion to USD 31.1 billion. The BRV has been actively refinancing its debt since 2003. Finance Ministry data show that debt service payments as a percentage of GDP decreased from 9.8 percent in 2002 to 5.1 percent in 2005 (equivalent to the pre-Chavez 1998 level). However, during this time, GDP increased 17.4 percent in 2004 and 9.3 percent in 2005.

13. (U) In February 2006, Finance Minister Merentes announced BRV plans to reduce debt to 27.4 percent of GDP in 12007. The BRV hopes this will improve the country risk ratings (measured as the spread between the Venezuela benchmark and U.S Treasury) from 213 to 200 basis points by the end of September, and that Venezuela's bonds will be considered investment grade. The BRV also hopes to free up resources for social needs, such as health and education. The Finance Ministry estimates saving USD 676 million in debt

service in 2006 and USD 450 million in debt service a year starting 2007. However, Finance Minister Merentes also announced that it could issue up to USD 4 billion of new bonds this year. Merentes denied BRV interest in issuing dollar-denominated bonds, fueling speculation that the BRV would issue euro-denominated bonds, payable in Bolivars, to ease exchange rate and inflationary pressures.

DOMESTIC DEBT STRATEGY

¶4. (U) The BRV's domestic debt strategy is focused on extending the maturity profile of the domestic debt that matures in years 2006-2008 to 2015. Approximately 78 percent of the outstanding domestic debt balance (USD 12 billion) is scheduled to come due in years 2006-2008, in contrast to the foreign debt payments which are not particularly concentrated. Approximately 85 percent of the domestic debt is in BRV public bonds. Local media report that the Finance Ministry is negotiating with banks to trade the BRV bonds for bonds with longer maturities, and potentially, a protection clause against a devaluation and interest rate decrease. The BRV has significant negotiating power with banks because banks hold approximately USD 6 billion in BRV deposits and roughly USD 6 billion in BRV bonds. As a result of this restructuring, the BRV expects to generate savings from refinancing at a lower interest rate and ensure that the costs to buy back maturing bonds and interests payments do not exceed USD 3 billion a year until year 2027.

¶5. (U) However, the BRV also is concerned about the potential monetary impact of restructuring domestic debt and

is coordinating with the Central Bank to avoid increasing liquidity (reftel). If the BRV were to purchase the domestic debt, this would inject Bolivars into the economy, increasing inflationary pressures. Instead, the BRV is leaning towards refinancing to change the maturity profile and costs of the domestic debt.

FOREIGN DEBT STRATEGY

¶6. (U) On February 28, 2005, Finance Minister Nelson Merentes announced that Venezuela will pre-pay Brady Bonds, and some of the bilateral and multilateral debt, reducing foreign debt stock by USD 4.7 billion (15 percent) to USD 26.350 billion. The BRV plans to use oil revenue to save Venezuela the interest costs on the debt, as well as push Chavez' agenda of reducing Venezuela's dependence on multilateral and bilateral institutions. Venezuela's bilateral and multilateral debt, which many economists described as largely low-interest and long-term, totals USD 4.787 billion. Approximately 68 percent of foreign debt is public bonds, 79 percent is at fixed rates, and 88 percent is dollar denominated. In a private transaction in late February or early March 2005, the BRV initiated its buyback strategy by pre-paying almost USD 700 million in Series A Brady bonds and Series B Discount Bradies. This debt is among Venezuela's highest cost foreign debt.

¶7. (U) The BRV also announced plans to use the National Development Fund (FONDEN) to pay off foreign debt. Reportedly, the BRV used USD 1 billion from FONDEN for the recent buy-back of Brady Bonds, and bilateral and multilateral debt, and funds from prior debt issuances. (Note: FONDEN was created by the Central Bank Law (July 2005) with USD 6 billion in "excess reserves" from the Central Bank. Estimates are that total FONDEN deposits since its creation could approach around USD 17 billion by year's end. This would include direct transfers from PDVSA of USD 1.5 billion in 2005 and USD 100 million per week in 2006 and an additional transfer of USD 4 billion from the BCV reserves. End Note.)

18. (SBU) The Chief of the Finance Ministry's Office of Public Credit, Rudolf Romer told EconOffs, that because the BRV intentionally underestimates oil income in the national budget, the BRV traditionally uses debt in the national budget to reach its desired spending total. In the end, Romer explained, the National Assembly passes additional credits to pay interest costs incurred. For 2006, USD 6.7 billion, 16.6 percent of the original budget expenditures (USD 40.5 billion), was allocated to cover debt service. USD 1.2 billion would come from ordinary revenues and USD 5.5 billion from public debt. The 2006 budget also included proposed USD 1.8 billion in new debt for specific projects. The BRV received authorization from the National Assembly to issue this debt (Annual Debt Law for 2006, Extraordinary Official Gazette 5,794, December 20, 2005), however, we do not know if the BRV will use the full authorization.

19. (SBU) Jose Guerra, former Manager of Economic Research for the Central Bank, criticized the BRV for issuing debt when it has sufficient resources in its accounts in the Central Bank and the private banking system. Guerra calculates that the net increase in debt cost the BRV USD 624 million in 2004 and 2005 in interest costs. Guerra argued that the management of the debt and public deposits has created powerful incentives for corruption (read: e.g. payment of "commissions" to BRV officials for preferential treatment in transactions). In local media, Guerra claimed that the projects funded under prior Annual Debt Laws were never completed. (Note: Economic contacts have widely reported corruption in the management of BRV resources in private banks. Private banks may use BRV deposited funds for lending or investments. As a result, the BRV may have additional need to borrow if deposited BRV funds are not accessible, when needed. End Note.)

COMMENT

10. (U) Overall, the new direction in the debt management strategy reduces the BRV's future liabilities with current oil windfall revenue. As in other BRV financial transactions, we have heard rumors of BRV officials earning "commissions" on debt transactions, which could potentially compromise the BRV debt management strategy. Also, election year spending pressures could delay the plan's full implementation. The BRV could also emphasize refinancing strategies over pre-paying debt with current revenues (e.g. revenues other than debt). Still, assuming a stable oil price scenario, the BRV will be swimming in oil revenue in 2006 and will have a great deal of flexibility to address its priorities.

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